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Segment information; Statement on auditing standards, 088

American Institute of Certified Public Accountants. Auditing Standards Executive Committee

Statement on Auditing Standards

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Segment Information[1]

1. Statement of Financial Accounting Standards No. 14, *Financial Reporting for Segments of a Business Enterprise*, requires the inclusion of certain information about an entity's operations in different industries, its foreign operations and export sales, and its major customers (referred to in this Statement as "segment information") in annual financial statements that are intended to present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. Disclosure of segment information requires the disaggregation of certain significant elements of an entity's financial statements, such as revenue, operating profit or loss, identifiable assets, depreciation, and capital expenditures. This Statement provides guidance to an auditor in examining and reporting on financial statements that are required to include segment information in conformity with FASB Statement No. 14.

2. Segment information is one of the disclosures required by generally accepted accounting principles as an integral part of financial statements. The purpose of segment information is stated in paragraph 5 of FASB Statement No. 14:

> The purpose of the information required to be reported by this Statement is to assist financial statement users in analyzing and understanding the enterprise's financial statements by permitting better assessment of the enterprise's past performance and future prospects. . . . information prepared in conformity with this State-

[1] The meaning of the term "segment information" in this Statement differs from that of the term "segment" in footnote 2 of SAS No. 14, *Special Reports*.

ment may be of limited usefulness for comparing a segment of one enterprise with a similar segment of another enterprise.

Auditor's Objective

3. The objective of auditing procedures applied to segment information is to provide the auditor with a reasonable basis for concluding whether the information is presented in conformity with FASB Statement No. 14 in relation to the financial statements taken as a whole. The auditor examining financial statements in accordance with generally accepted auditing standards considers segment information, as other informative disclosures, in relation to the financial statements taken as a whole, and is not required to apply auditing procedures that would be necessary to express a separate opinion on the segment information.

Auditing Procedures

4. Paragraphs 5-7 of this Statement provide guidance as to auditing procedures when financial statements include segment information. If an entity represents to the auditor that it does not have industry segments, foreign operations, export sales, or major customers required to be disclosed by FASB Statement No. 14, the auditor should follow the guidance in paragraph 15 of this Statement.

5. The auditor applies the concept of materiality, discussed in section 150.04 of SAS No. 1, in determining the nature, timing, and extent of auditing procedures to be applied in an examination of financial statements. Materiality of segment information is evaluated primarily by relating the dollar magnitude of the information to the financial statements taken as a whole. However, as with other elements of financial statements, the materiality of segment information does not depend entirely on relative size; the concept involves qualitative as well as quantitative judgments. (A discussion of materiality as it relates to the auditor's report is included in paragraph 8 of this Statement.)

6. In planning his examination, it may be necessary for the auditor to modify or redirect selected audit tests to be applied to the financial statements taken as a whole. For example, the auditor may decide to select inventories for physical observation on the basis of industry segments or geographic areas. Factors such as the following should be considered by the auditor in determining whether his procedures should be modified or redirected:

a. Internal accounting control and the degree of integration, centralization, and uniformity of the accounting records.

b. The nature, number, and relative size of industry segments and geographic areas.

c. The nature and number of subsidiaries or divisions in each industry segment and geographic area.

d. The accounting principles used for the industry segments and geographic areas.

In any event, the tests of underlying accounting records normally applied in an examination of financial statements should include a consideration of whether the entity's revenue, operating expenses, and identifiable assets are appropriately classified among industry segments and geographic areas.

7. In addition, the auditor should apply the following procedures to segment information presented in financial statements:

a. Inquire of management concerning its methods of determining segment information, and evaluate the reasonableness of those methods in relation to the factors identified in FASB Statement No. 14 for making those determinations.[2]

b. Inquire as to the bases of accounting for sales or transfers between industry segments and between geographic areas, and test, to the extent considered necessary, those sales or transfers for conformity with the bases of accounting disclosed.

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[2] Paragraphs 11-21 and Appendix D of FASB Statement No. 14 discuss how an entity's industry segments and reportable segments should be determined. Paragraph 34 of that Statement describes factors to be considered in grouping the countries in which an entity operates into geographic areas, and paragraphs 36 and 39 describe criteria for disclosing export sales and major customers, respectively.

c. Test the disaggregation of the entity's financial statements into segment information. The tests should include (1) an evaluation of the entity's application of the various percentage tests specified in paragraphs 15-20 and 31-39 of FASB Statement No. 14, and (2) an analytical review of the segment information, including inquiries concerning relationships and items that appear to be unusual. The analytical review consists of (1) comparison of the current-year segment information with that of the previous year and any available related budgeted information for the current year, (2) consideration of the interrelationships of elements of the segment information that would be expected to conform to a predictable pattern based on the entity's experience (for example, operating profit as a percentage of both total revenue and identifiable assets by industry segment or geographic area), and (3) consideration of the types of matters that in the preceding year have required accounting adjustments of segment information.

d. Inquire as to the methods of allocating operating expenses incurred and identifiable assets used jointly by two or more segments, evaluate whether those methods are reasonable, and test the allocations to the extent considered necessary.

e. Determine whether the segment information has been presented consistently from period to period and, if not, whether the nature and effect of the inconsistency are disclosed and, if applicable, whether the information has been retroactively restated in conformity with paragraph 40 of FASB Statement No. 14.

Reporting

8. The auditor's standard report on financial statements prepared in conformity with generally accepted accounting principles implicitly applies to segment information included in those statements in the same manner that it applies to other informative disclosures in the financial statements that are not clearly marked as "unaudited."[3] The auditor's standard report would not refer to segment

[3] If an entity discloses comparative segment information for fiscal years beginning prior to December 15, 1976, that information should be clearly marked as "unaudited" unless the auditor has applied to that segment infor-

information unless his examination revealed a misstatement or omission, or a change in accounting principle, relating to the segment information that is material in relation to the financial statements taken as a whole, or the auditor was unable to apply the auditing procedures that he considered necessary in the circumstances. The auditor should consider qualitative as well as quantitative factors in evaluating whether such a matter is material to the financial statements taken as a whole. The significance of a matter to a particular entity (for example, a misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity), the pervasiveness of a matter (for example, whether it affects the amounts and presentation of numerous items in the segment information), and the impact of a matter (for example, whether it distorts the trends reflected in the segment information) should all be considered in judging whether a matter relating to segment information is material to the financial statements taken as a whole. Accordingly, situations may arise in practice where the auditor will conclude that a matter relating to segment information is material to the financial statements taken as a whole even though, in his judgment, it is quantitatively immaterial to those financial statements.

Misstatement or Omission of Segment Information

9. If the auditor's examination reveals a misstatement in the segment information that is material in relation to the financial statements taken as a whole and that misstatement is not corrected, the auditor should modify[4] his opinion on the financial statements because of a departure from generally accepted accounting principles. The following is an example of an auditor's report qualified because of a misstatement of segment information.

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mation the auditing procedures set forth in this Statement. If the auditor concludes, on the basis of facts known to him, that segment information marked "unaudited" is not in conformity with FASB Statement No. 14 in relation to the financial statements taken as a whole, he should follow the guidance in section 516.06 of SAS No. 1.

[4] The term "modify" in this context means to express a qualified or an adverse opinion.

(Explanatory paragraph)

With respect to the segment information in Note X, $...... of the operating expenses of Industry A were incurred jointly by Industries A and B. In our opinion, Statement No. 14 of the Financial Accounting Standards Board requires that those operating expenses be allocated between Industries A and B. The effect of the failure to allocate those operating expenses has been to understate the operating profit of Industry A and to overstate the operating profit of Industry B by an amount that has not been determined.

(Opinion paragraph)

In our opinion, except for the effects of not allocating certain common operating expenses between Industries A and B, as discussed in the preceding paragraph, the financial statements referred to above present fairly . . .

10. If the entity declines to include in the financial statements part or all of the segment information that the auditor believes, based on his knowledge of the entity's business, is required to be disclosed, the auditor should modify his opinion on the financial statements because of inadequate disclosure and should describe the type of information omitted.[5] The auditor is not required to provide the omitted information in his report.[6] The following is an example of an

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[5] This requirement is applicable whether or not the financial statements include a statement of changes in financial position.

[6] In view of the provisions of this sentence, the following changes are made: The first sentence of section 430.04 of SAS No. 1, the third sentence of section 545.01 of SAS No. 1, and second sentence of paragraph 17 of SAS No. 2 are amended to read:

> If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express a qualified or an adverse opinion because of the departure from those principles and should provide the information in his report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific Statement on Auditing Standards.

The first two sentences of section 545.05 of SAS No. 1 are amended to read:

> If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should provide the information in his report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific Statement on Auditing Standards. The auditor is not required to prepare a basic financial statement (a statement of changes in financial position for one or more years) and include it in his report if an entity declines to present the statement.

The following paragraph and footnote are to be added to the end of section 516 of SAS No. 1:

> Statement of Financial Accounting Standards No. 14, *Financial Report-*

auditor's report qualified because of an omission of segment information.

(Explanatory paragraph)

The Company declined to present segment information for the year ended December 31, 19XX. In our opinion, presentation of segment information concerning the Company's operations in different industries, its foreign operations and export sales, and its major customers is required by Statement No. 14 of the Financial Accounting Standards Board. The omission of segment information results in an incomplete presentation of the Company's financial statements.

(Opinion paragraph)

In our opinion, except for the omission of segment information, as discussed in the preceding paragraph, the financial statements referred to above present fairly . . .

Consistency

11. Paragraph 67 of FASB Statement No. 14 states:

> . . . consistency from period to period in the methods by which an enterprise's segment information is prepared and presented is as important as consistency in the application of the accounting principles used in preparing the enterprise's consolidated financial statements.

An inconsistency in segment information may occur because of—

a. A change in the bases of accounting for sales or transfers between industry segments or between geographic areas, or in the meth-

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ing for Segments of a Business Enterprise, requires the inclusion of certain information about an entity's operations in different industries, its foreign operations and export sales, and its major customers (referred to as "segment information") in annual financial statements that are intended to present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. When a certified public accountant who is associated with such annual financial statements that are unaudited concludes, based on facts known to him, that segment information is required to be disclosed and the entity declines to include such disclosures in its financial statements, the accountant should indicate in his disclaimer of opinion that the financial statements do not conform with generally accepted accounting principles because segment information is not presented.* The accountant is not required to prepare omitted segment information and include it in his disclaimer of opinion.

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*This requirement is applicable whether or not the financial statements include a statement of changes in financial position.

ods of allocating operating expenses or identifiable assets among industry segments or geographic areas (paragraphs 23, 24, and 35a of FASB Statement No. 14).

b. A change in the method of determining or presenting a measure of profitability for some or all of the segments (paragraphs 25 and 35b of FASB Statement No. 14).

c. A change in accounting principle as discussed in APB Opinion No. 20, *Accounting Changes* (paragraph 27d of FASB Statement No. 14).

d. A change requiring retroactive restatement as discussed in paragraph 12 of this Statement.

12. Paragraph 40 of FASB Statement No. 14 requires that segment information for prior periods that is disclosed in comparative financial statements be retroactively restated if—

a. The financial statements of the entity as a whole have been retroactively restated.

b. The method of grouping products and services into industry segments or of grouping foreign operations into geographic areas is changed and the change affects the segment information disclosed.

13. FASB Statement No. 14 requires that the nature and effect of the changes indicated in paragraphs 11 and 12 be disclosed in the period of the change. If the nature and effect of a change are not disclosed or, if applicable, the segment information is not retroactively restated, the auditor should modify his opinion because of the departure from generally accepted accounting principles. The following is an example of an auditor's report qualified because of an entity's failure to disclose the nature and effect of a change in the basis of accounting for sales between industry segments.

(Explanatory paragraph)

In 19XX, the Company changed the basis of accounting for sales between its industry segments from the market price method to the negotiated price method, but declined to disclose the nature and effect of this change on its segment information. In our opinion, disclosure of the nature and effect of this change, which has not been determined, is required by Statement No. 14 of the Financial Accounting Standards Board.

(Opinion paragraph)

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly . . .

14. A modification of the auditor's report as to consistency is not required for the changes indicated in paragraphs 11 and 12 except for a change in accounting principle that affects the financial statements taken as a whole (paragraph 11c), in which case the auditor should also follow the guidance in sections 420 and 546 of SAS No. 1.

Scope Limitation

15. An entity may represent to the auditor that it does not have industry segments, foreign operations, export sales, or major customers required to be disclosed by FASB Statement No. 14. The auditor ordinarily would be able to conclude, based on his knowledge of the entity's business, whether the entity has such industry segments, foreign operations, export sales, or major customers. If the auditor is unable to reach a conclusion based on that knowledge and the entity declines to develop the information he considers necessary to reach a conclusion, the auditor should indicate in the scope paragraph of his report the limitation on his examination and should qualify his opinion on the financial statements taken as a whole. The following is an example of an auditor's report qualified because of the auditor's inability to conclude whether the entity is required to present segment information.

(Scope paragraph)

. . . Except as explained in the following paragraph, our examination . . . and such other auditing procedures as we considered necessary in the circumstances.

(Explanatory paragraph)

The Company has not developed the information we consider necessary to reach a conclusion as to whether the presentation of segment information concerning the Company's operations in different industries, its foreign operations and export sales, and its major customers is necessary to conform with Statement No. 14 of the Financial Accounting Standards Board.

(Opinion paragraph)

In our opinion, except for the possible omission of segment information, the financial statements referred to above present fairly...

16. The auditor should also qualify his opinion on the financial statements taken as a whole if he is unable to apply to reported segment information the auditing procedures that he considers necessary in the circumstances. The following is an example of an auditor's report qualified because the entity has specified that the auditor should not apply to reported segment information the auditing procedures that he considered necessary in the circumstances.

(Scope paragraph)

. . . Except as explained in the following paragraph, our examination . . . and such other auditing procedures as we considered necessary in the circumstances.

(Explanatory paragraph)

In accordance with the Company's request, our examination of the financial statements did not include the segment information presented in Note X concerning the Company's operations in different industries, its foreign operations and export sales, and its major customers.

(Opinion paragraph)

In our opinion, except for the effects of such adjustments or disclosures, if any, as might have been determined to be necessary had we applied to the segment information the procedures we considered necessary in the circumstances, the financial statements referred to above present fairly . . .

Reporting Separately on Segment Information

17. The auditor may be requested to report separately on segment information, either in a special report or as part of his report on the financial statements taken as a whole. In such an engagement, the measurement of materiality should be related to the segment information itself rather than to the financial statements taken as a whole. Consequently, an examination of segment information for the purpose of reporting on it separately is more extensive than if the same information were considered in conjunction with an examination of the financial statements taken as a whole.

18. Paragraphs 10-13 of SAS No. 14, *Special Reports*, provide guidance that is applicable to reporting separately on segment information. However, since segment information is one of the disclosures required by generally accepted accounting principles, all of the generally accepted auditing standards are applicable to an engagement to report separately on segment information. Thus, the first and second standards of reporting apply. The auditor should indicate in his report whether, in his opinion, the segment information is presented fairly in conformity with generally accepted accounting principles, and should report on the changes discussed in paragraphs 11 and 12 of this Statement.

The Statement entitled "Segment Information" was adopted unanimously by the twenty-one members of the Committee, of whom three, Messrs. Cook, Grifferty, and Thomas, assented with qualification.

Messrs. Cook, Grifferty, and Thomas approve the issuance of this Statement, but qualify their assent with respect to paragraph 6. They believe that the reference in paragraph 6 to modification or redirection of basic auditing procedures is unclear and may be misinterpreted as indicating that (1) the auditor's approach to examining accounting records underlying financial statements containing disclosure of segment information should be directed to such segment information rather than to the financial statements of the business enterprise taken as a whole and (2) the auditor should expand his basic auditing procedures solely because of the disclosure of segment information. They believe that these interpretations would be inconsistent with the objective of auditing procedures stated in paragraph 3 of the Statement and might result in users of financial statements containing disclosure of segment information imputing a higher degree of precision to such information than that intended by FASB Statement No. 14 .

Auditing Standards Executive Committee (1977-1978)

Note: *Statements on Auditing Standards are issued by the Auditing Standards Executive Committee, the senior technical committee of the Institute designated to issue pronouncements on auditing matters. Rule 202 of the Institute's Code of Professional Ethics requires adherence to the applicable generally accepted auditing standards promulgated by the Institute. It recognizes Statements on Auditing Standards as interpretations of generally accepted auditing standards and requires that members be prepared to justify departures from such Statements.*